IRAN DIVESTMENT BACKGROUND

The California Public Divest from Iran Act (Act) enacted in Assembly Bill 221 (Anderson), became effective January 1, 2008.

The Act:

- Prohibits the California Public Employees Retirement System (CalPERS) and California State Teachers Retirement System (CalSTRS) from investing public employees retirement funds in companies that have specified energy or defense-related operations in Iran;

- Requires the hiring of a research firm to determine those companies that have business operations in Iran;

- Requires the boards to independently review publicly available information regarding companies with business operation in Iran and to take specific actions based on that review by March 30, 2008;

- Requires liquidation of investments in companies identified as meeting specified criteria within 18 months after they are found to be in violation;

- Requires the Boards to report to the Legislature annually on their investments with companies with specified business operations in Iran.

No divestments have yet occurred in the more than two years since the Act was implemented.

California is one of nineteen states that have passed legislation to end or deter pension funds from investing in companies that do business in Iran. Many of these states have found a conflict between their fiduciary responsibility in managing public funds and the goal of divestment.

CalPERS and CalSTRS use an approach that involves active discussion and informing companies of the Act, the value of the investment held, and how this is viewed as a risk given current international relations.

In order to monitor companies with various levels of business activity in Iran, CalPERS hired RiskMetrics Group (RMG) to apprise them of the status of companies in which it has investments. RMG also follows the business activities and agreements of companies all over the world to identify likely or emerging investments in Iran.

Initially, CalSTRS retained KLD Research & Analytics, Inc. to monitor business activity in companies contained in CalSTRS' portfolio. KLD was bought by RiskMetrics Group (RMG) in late 2009 and RMG continues with efforts on behalf of both CalPERS and CalSTRS today.

BACKGROUND - RISKMETRICS GROUP

RiskMetric Group (RMG) is a company specializing in research and analysis to bring transparency to corporate investments. RMG finds financial markets are opaque and they have developed tools and expertise in the past ten years to track business involvement around the world.

RMG has followed business relationships in and with Iran for over ten years and as a result, have developed software and information systems that provide an extensive array of business relationships involving Iran. This experience also provides RMG with the knowledge of company and country links to initiate informed, targeted searches.

Services are provided to a wide range of clients in corporate business and to 9 of the top 10 and 41 of the top 100 public pension funds.

RMG tracks and monitors every publicly traded company and has identified 200-250 companies in Iran. Of those, approximately 60 would be covered by the California Public Divest from Iran Act (Act) that is focused on a company that is:

- (A) Engaged in business operations with entities in the defense or nuclear sectors of Iran, or
- (B) Invested in or engaged in business operations with entities involved in the development of petroleum or natural gas resources of Iran, and
- (C) Subject to sanctions under Public Law 104-172, as renewed and amended in 2001 and 2006.

According to RMG, of the monitoring work they have done over the past three years, involvement of companies in Iran have remained relatively steady. There have been changes in terms of companies leaving and different companies coming in but overall, there has been no noticeable change in overall volume.

CalPERS and the CALIFORNIA PUBLIC DIVEST from IRAN ACT

CalPERS is the largest public pension plan in the United States, responsible for over $200 billion in global assets, which are invested to provide retirement and health benefits for over 1.6 million Californians.

The CalPERS Board is responsible for ensuring that these assets are managed with prudence and care, in the sole interests of its beneficiaries, who rely upon these investments to finance three-quarters of the benefits they receive. CalPERS distributes over $18 billion a year to pensioners and employees for their health and retirement needs.

The CalPERS Board believes that constructive engagement through share ownership is the most powerful tool investors can use to affect change at those companies whose corporate governance, social, or environmental practices could lead to value destruction.

To fulfill the provisions of the California Public Divest from Iran Act (Act), CalPERS engages companies through certified mail, phone calls, emails, faxes, and if need be, translating correspondences and actively pursuing responses from parent companies where decisions will be made.

There is evidence that companies are exiting Iran and that could be attributable to stakeholder engagement to some degree:

- The 2009 legislative report listed 23 companies with business operations in Iran, a 50% reduction from the original 47 companies identified on 6/30/08.
- On 1/4/10 Petrobras, Brazil's state - controlled oil firm, announced its exit from Oil and Natural Gas Corp's prolific gas discovery block in Iran.

CalPERS, based on an analysis conducted by Wilshire Consulting in January 2010, determined that CalPERS presently cannot both divest and fulfill its fiduciary responsibility to CalPERS members.

- The analysis showed divesting from the companies subject to the Iran Act would have a deleterious impact on investment performance.
- The Projected *transaction costs* to divest range from $5.83 million to $23.32 million.
- Projected annual impact of Iran Divestment/Exclusion assuming optimized reinvestment ranges from + $127 million (1 in 5 Yrs) to + $194 million (1 in 20 Yrs).

The Act requires that CalPERS identify companies with certain business operations in Iran, as defined in the Act, or which provide revenue to the government of Iran. Then full notification is provided to each company concerned, setting out the provisions of the Iran Act, and seeking a substantial response that can be properly assessed.

To ensure high-level engagement, letters were couriered to the most senior board member of each company, for example, the Chairman, CEO or President. The critical provisions are those in the Iran Act that relate to exemption through boycotting the government, curtailing business,

and selling company assets, equipment and property. CalPERS has also carefully considered petitions for exclusion on grounds of humanitarian activity and
ensured that the intention of the Act has been firmly applied.

Following the research and assessment set out above, the statute then provides that CalPERS divest its shares in those companies that have not provided evidence of exemption from the Act's provision, within 90 days of being notified. The Act specifies that this does not "require the board to take action as described…unless the board determines, in good faith, that the action…is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution (section 7.K 7513.7 California Public Divest From Iran Act)."

As of December 2009, CalPERS held portfolio positions in 24 companies that are actively engaged in Iran. Within this group, 4 were newly identified with engagement about to begin (the process of contacting and attempting to influence companies to divest). As required by the Act, these investments are reviewed to determine business activity in Iran.

CalPERS has tracked significant progress in company withdrawal and reduction of activity in Iran. Companies continue to withdraw—whether in reaction to public disfavor or uncertainty over investments. Others decide not to pursue planned investment, even when this allows competitors to step in—possibly for the same reasons companies withdraw or because the amount of business is not worth the risk of alienating consumers.

CalSTRS and the CALIFORNIA PUBLIC DIVEST from IRAN ACT

The California State Teachers' Retirement System (CalSTRS) was established in 1913 and is the largest U.S. teachers' retirement fund and the second largest public pension fund in the United States with an investment portfolio of about $138.0 billion as of March 31, 2010. This is an increase in value of $4 billion since last report December 31, 2009.

It serves 833,000 public school administrators, K-12 teachers, community college instructors and their families. The system provides benefits including retirement, disability and survivor benefits to members, retirees, and their survivors.

CalSTRS is governed by a twelve-member Board that sets policies and makes rules and administers the system but has no authority to set contribution rates. The board selects a Chief Investment Officer to direct the investment of the Teachers' Retirement Fund in accordance with board policy but the Board has the final authority.

"One of the Board's core values is to ensure the strength of the retirement system by proactively addressing the risks of investing. This value permeates the investment portfolio, where the Board has adopted the Investment Policy for mitigating Environmental, Social, and Geopolitical Risks (ESG). The policy requires managers to consider 21 separate risk factors when investing for CalSTRS. A copy of the policy is included as Attachment A." (See next page.)

CalSTRS presentation February 24, 2010

As directed by the California Public Divest from Iran Act (Act), CalSTRS identified and created a list of companies noted as having some level of, or possible business ties to Iran such as operations in oil, nuclear or defense industries.

The Act requires investments in Iran that violate the Act to be sold within 18 months after identification. The Act also, however, specifies that this does not “require the board to take action as described…unless the board determines, in good faith, that the action…is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution (section 7.K 7513.7 California Public Divest From Iran Act).”

The initial list contained 23 companies in various categories and was presented to the Board in June 2008. In additon to restricted companies, CalSTRS reported last year that it had identified 19 additional companies in its portfolio with possible ties to Iran.

CalSTRS engages these companies through conference calls, letters and face-to-face meetings with senior executives whenever possible in an attempt to influence withdrawal from Iran. CalSTRS does not find it financially prudent to these sell holdings at this time.

CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM

The concept of shareholder activism has been advanced for over twenty years in relation to investments.

Shareholder activism has two objectives: to affect a particular corporate practice and to change what the public thinks of it. Each year dozens of resolutions dealing with social or political issues appear on proxy ballots for investor shareholder meetings. Thus, shareholder activism goes hand in hand with investment decisions. This type of activity has influenced mission-based investing on issues like military weapons production or the abolition of apartheid in South Africa.

California has adopted a number of activist causes in relation to investing by CalPERS and CalSTRS with the most recent addition being divestment from Iran in the California Divest from Iran Act (Act).

The Act specifies it does not "require the board to take action as described…unless the board determines, in good faith, that the action…is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution (section 7.K 7513.7 California Public Divest From Iran Act)."

Thus, there is a conflict between social conscience and fiduciary responsibility.

Both CalPERS and CalSTRS have attempted to engage companies identified as having ties to Iran through business channels and written, verbal and face-to-face communication.

An organization with similar goals and a different technique is United Against Nuclear Iran (UANI), an organization founded by a former U.S. Ambassador to the United Nations to encourage companies to end their business in Iran and to identify companies that have failed to disclose to investors the legal and financial peril associated with their business dealings in Iran. The approach taken by UANI is aggressive and uses high-profile public tactics like a letter to the company requesting cessation of business activities in Iran the same day a press release publicizes that company's involvement in Iran. In one instance, UANI placed a billboard with the picture and name of the product next to a picture of the President of Iran and the message:

Today's work Tomorrow's nuclear Iran?
Stop…business in Iran

If consumers become aware of a company's business involvement with Iran, the net result is a more informed consumer. If consumers hold a moral or political concern to be of greater importance than pocketbook concerns, they may choose to weigh-in and attempt to alter investment policy. Ultimately, the respective Boards would undoubtedly take such concerns into their deliberations if a large segment of their membership voiced similar concerns.